CalPERS

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Agenda Item 4c

June 14, 2011

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: AB 1320 (Allen) – As Amended May 27, 2011
Taxpayer Adverse Risk Prevention (TARP) Accounts

Sponsor: California Professional Firefighters

II. PROGRAM: Legislation

III. RECOMMENDATION: For Information Only

IV. ANALYSIS:

Summary

AB 1320 would establish within the Public Employees' Retirement Fund (PERF), administered by CalPERS, a pension contribution stabilization account for each employer called a Taxpayer Adverse Risk Prevention (TARP) Account. The TARP would be funded by all or a portion of employer contributions when the actuarial value of assets exceeds the present value of benefits. Employers would be required to always pay a rate equal to no less than the normal cost of benefits; excess contributions would fund the account. The account would be drawn upon to pay a portion of the employer contribution when the employer contribution rate is greater than the normal cost of benefits.

This bill would establish similar accounts for the counties affected by the County Employees Retirement Law of 1937. This analysis will only consider the impact of the bill on CalPERS.

Background

CalPERS Valuation Process

Generally, employee contributions are a fixed percentage of salary, and employer contributions fluctuate based on the annual actuarial valuation of retirement system assets compared to liabilities. When investment earnings on assets are high, employer contributions can generally be reduced, and when investment earnings are low, employer contribution rates generally are increased.

When CalPERS staff performs an actuarial valuation, both the present value of benefits and the actuarial accrued liability are calculated. The actuarial accrued liability is usually the amount needed on hand to pay for all accrued benefits. The present value of benefits, however, is the present value of the amount needed to fully fund both past and future service. Employer rates are based on the actuarial accrued liability. If assets on hand exceed the actuarial accrued liability, then the employer rate would be less than the normal cost of benefits. If the assets are less than the actuarial accrued liability, the employer rate would be greater than the normal cost.

Employer Rate Stabilization Policy

In 2005 the Board adopted an Employer Rate Stabilization Policy to help reduce volatility in the employer contribution rates. This policy made changes to the Board’s existing actuarial asset smoothing policy and amortization policy, and added a new minimum contribution policy. In order to minimize contribution holidays, this policy requires that any surplus be amortized over a period of 30 years. Under this policy, employers can still obtain a full contribution holiday especially if they are very well funded. The 30 year period was selected to be consistent with Government Account Standard Board (GASB) requirement that any surplus cannot be amortized over a period exceeding 30 years.

Pension Contribution Stabilization Accounts

Pension contribution stabilization accounts are intended to reduce or eliminate large fluctuations in the amount an employer is required to contribute to the retirement fund, as well as to act as a source of benefit funding when employer revenues are reduced by economic or other conditions.

Generally, where the employer realizes revenues in excess of specified cost projections, the employer would provide a contribution to the stabilization account over and above its otherwise required contribution amount to the retirement fund. Where the employer realizes revenues less than specified cost projections, money from the stabilization account could be contributed to the employer’s retirement fund as a partial or full offset to the employer’s otherwise required contribution.

CalPERS staff presented the concept of Pension Contribution Stabilization Accounts to the Board in 2005 as one of a number of possibilities to assist employers with the budgeting challenges caused by fluctuations in the employer required contribution rate to the pension plan. Overall, in each design type studied, staff concluded that the recently adopted Employer Rate Stabilization Policy greatly reduced the need for rainy day funds and the chance for success of such funds. Staff determined that the idea of rainy day funds could be revisited once it was determined how the new smoothing methods are working.

PEBC Recommendation on Pension Holidays

The January 2008 final report from Governor Schwarzenegger's Post-Employment Benefits Commission (PEBC) recommended that:

> "Generally, employer contributions should not fall to zero. An employer should be permitted to have a full or partial contribution holiday only when its retirement plan is substantially overfunded. As used here, "substantially overfunded" means that the existing surplus is used to pay for all or part of the normal cost only after that surplus is amortized over a 30 year period, the longest amortization period allowed by GASB. In particular, employer contributions should fall to zero ("full contribution holiday") only in the rate situation that the surplus is so great that it could be expected to fund a full 30 years of normal costs."

Proposed Changes

Specifically, this bill would:

1. Require CalPERS and the '37 Act County Retirement System to establish in their respective retirement funds, a Taxpayer Adverse Risk Prevention Account for each employer.

2. Require that deposits would be made with all or a portion of employer contributions when the actuarial value of assets (exclusive of funds in the TARP Account) exceeds the present value of benefits.

3. Require that the assets of the account would be drawn upon to pay a portion of the employer contribution when the employer contribution rate is greater than the normal cost of benefits.

4. Allow employer contribution rates to be reduced when an employer's TARP Account exceeds an amount greater than 50 percent of the employer's assets, excluding the assets in the TARP.

5. Allow funds in the TARP to be used to reduce other contributions, such as retiree health or employee contributions.

6. Require funds in the TARP to be invested with the other assets of the system.

7. Allow transfers of assets into or out of TARP Accounts as of January 1, 2013.

Legislative History

2005 SBX1 2 (Dunn) – Would have required PERS and the '37 Act county retirement systems to establish TARP Accounts for each participating employer in order to mitigate sudden increases in contribution rates. This bill died in the Senate Appropriations Committee. *CalPERS position: None*

2005 SB 880 (Ashburn) – Would have authorized the CalPERS Board and the retirement boards of city, county, city and county, and district retirement systems to create Pension Contribution Stabilization Accounts. This bill died in the Senate Public Employment and Retirement Committee. *CalPERS position: None*

2005 ABX1 4 (Torrico) – Would have required PERS and the '37 Act county retirement systems to establish Taxpayer Risk Reduction (TRR) Accounts for each participating employer in order to mitigate sudden increases in contribution rates. This bill died in the Assembly Ways and Means Committee (Extraordinary Session Committee). *CalPERS position: None*

Issues

1. Arguments in Support

   According to the author:

   "By ensuring that CalPERS and the '37 Act county retirement systems establish TARP accounts for each participating employer, AB 1320 will ultimately safeguard against any sudden increases in employer contribution rates, thereby providing budgeting stability and sustainability."

   Support: California Professional Firefighters (Sponsor); California Labor Federation; California Public Defenders Association; Laborers' Locals 777 & 792; San Diego County Court Employees Association.

2. Arguments in Opposition

   There is no known opposition at this time.

3. AB 1320 Could Impinge on the Board's Authority

   Article XVI, section 17 of the California Constitution gives the Board the sole authority and exclusive power to provide for the actuarial services in order to assure the competency of the assets of the System. While it may not be the intent of the author, the bill as written could impinge on the Board's authority to set the employer contribution rate.

   To address this conflict, the bill should be amended to provide that it will not be construed to interfere with the Board's authority or fiduciary responsibility as set forth in Section 17 of Article XVI, section 17 of the California Constitution, nor be construed to interfere with the actuary's rate setting processing or require the Board to adopt a rate other than rate adopted by the actuary. Instead, it should only require the employer to contribute an additional amount into the TARP if the board adopts a rate below the normal cost.

4. TARP Accounts Would Be Held For the Exclusive Benefit of Members

   The bill specifies that the TARP Accounts would be created within the PERF. It also provides that TARP Accounts are "employer assets." The PERF, however, is established for the exclusive benefit of plan members. Accordingly, the bill should be amended to provide that TARP Accounts are PERF Assets, not employer assets. Similarly, the bill allows funds in the TARP Accounts to be used for purposes other than offsetting employer pension contributions, including the funding of member contributions and retiree health benefit obligations.

   If the intent of the bill is actually to create separate trust funds that are employer assets that may be used to pay a variety of retirement benefits, then the accounts would have to be established outside of the PERF. Therefore, consideration should be given to evaluating whether the best method of accounting for pension stabilization funds is a separate trust fund outside the PERF.

5. There is No Data To Verify the Value of a TARP Account.

   This bill would require that the employer contribution rate would never fall below the normal cost of benefits, eliminating any potential "contribution holidays." As a result, excess funds may be available to help offset employer contribution rates when those rates increase beyond the normal cost of benefits. The TARP account is not designed to reduce overall employer costs, but rather to reduce annual fluctuations in employer contribution rates.

When the Board considered the possible methods for employer rate stabilization in 2005, it elected to establish a smoothing package, and chose to evaluate the success of smoothing before electing to establish the TARP Accounts. In addition, the Board adopted a minimum contribution policy as part of the smoothing package, which would have prevented the State's contribution holiday in 1999-2000. With this minimum contribution policy in place, very little money would go into the TARP Accounts, if they were established, and could possibly force employers that are already superfunded to put money in these accounts.

Back in December 2005, the Actuarial Office presented to the Board the result of an analysis on the ability for TARP to help employers pay for rising pension cost in "bad" years. The analysis showed that likelihood of funds being in the TARP when needed was very low. In addition, considering the fact that most plans at CalPERS are between 60 percent and 70 percent funded, it is unlikely that any funds would be deposited in such accounts for a number of years.

In the December 2005 report to the Board, several issued were raised as needing further analysis if TARP accounts were to be pursued. These issues included:

- What legislation and/or regulations would be needed to create rainy day funds?
- If implemented, should rainy day funds be voluntary or mandatory?
- If implemented, should rainy day funds be held at CalPERS, by the employer(s), or by some other entity?
- What, if any, are the accounting issues associated with creating rainy day funds?
- What does an actuarial analysis demonstrate about the viability of rainy day funds? That is, will they work?

Many of these issues should be analyzed before TARP accounts are created.

6. The Bill Contains Conflicting Provisions

   In one section AB 1320 states that the deposits to a TARP account shall be made when the actuarial value of assets exceed the **present value of benefits**, then in another section it states the employers' actual contribution not be less than the normal cost of benefits. If the intention of the bill is have the employer contribute to the TARP the difference between the employer rate set by the actuary and the employer normal cost, then the deposits to the TARP account should be made when the plan has any surplus; that is, when the actuarial value of assets exceeds the **actuarial accrued liability**.

7. Investment of TARP Account Funds Within the PERF

   AB 1320 requires that funds in the TARP account be invested "along with" other retirement assets. Because the TARP accounts would be established within the PERF, the Board would have constitutional authority and fiduciary responsibility for the investment of TARP account funds. Whether CalPERS were to invest TARP assets, and allocate income, differently than other PERF assets would have to be determined by the Board in light of its constitutional authority and fiduciary responsibility.

   Another issue linked with investing the TARP account within the PERF is the fact that the money in the TARP accounts would likely be at low levels when employers would need them since employer contribution rates increase following years where the investment return is below expectations. For example, had TARP been in place in 2008-2009 when CalPERS had a negative 24 percent return, the assets in these accounts would have decreased by 24 percent just prior to the time when they would have been needed.

   Investing the TARP accounts outside the PERF would make it easier to adopt a different asset allocation strategy than the one adopted for the PERF.

8. Implementation Date of TARP Account Program

   CalPERS is in the midst of implementing the Pension System Resumption (PSR) Project, a significant information technology effort involving all facets of CalPERS operations. The project is currently scheduled to implement the first phase on September 19, 2011, and incorporating any new legislation into the scope of the project at this time would not be possible without delaying the current launch date. Delaying the launch date would have significant financial implications to CalPERS and our vendor, in excess of one million dollars per week, in addition to the complexities of re-planning a new launch date internally and externally.

Implementing new legislation post launch will also be problematic due to on-going contractual obligations with our vendor and the need for a stabilization period with our internal and external customers. It is recommended that large program changes due to legislation such as AB 1320 not become effective until January 1, 2014.

9. Requirements of the Governmental Accounting Standards Board (GASB)

If enacted, this bill would impose additional financial reporting upon employers. As mentioned above, the Governmental Accounting Standards Board (GASB) requires that any surplus cannot be amortized over a period exceeding 30 years. If this bill is enacted, employers would be required to report an Annual Requirement Contribution (ARC) based on a 30 year amortization of surplus and report in their financial statements a prepaid expense and keep track each year of any differences in the contribution amount paid to CalPERS and the ARC reported in their financial statements.

10. Overfunded Rate Plans

While this proposal would not have an immediate impact on most public employers, there are 122 rate plans that the Chief Actuary has determined are overfunded and are expected to contribute less than the normal cost for the period July 1, 2011 to June 30, 2012. If this proposal becomes law, the employers of these 122 rate plans would be required to submit the normal cost to CalPERS.

Requiring employers that currently have a superfunded plan (actuarial value of assets exceeds the present value of benefits) could also lead to excessively large surpluses that could potential lead to pressure for benefit improvements. A superfunded plan is considered to already have enough assets to pay for all past and expected future service accrual. Requiring contributions from these employers could be seen as funding with the sole intent of creating a surplus. There are currently 21 employers that have a superfunded plan at CalPERS. The bill should be amended to provide that if the Board determines that the receipt of TARP contributions would conflict with its plenary authority or its fiduciary responsibility, the Board may refuse to receive such contributions.

11. Legislative Policy Standards

The Board's Legislative Policy Standards do not specifically address the issues in this bill. However, staff is supportive of the concept of no "contribution holidays", but additional time is needed to work with the stakeholders on the most effective approach.

V. STRATEGIC PLAN:

This is not a product of the CalPERS strategic plan, but an ongoing responsibility of the CalPERS Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Cost:

The TARP account is not designed to reduce overall employer costs, but rather to reduce annual fluctuations in employer contribution rates. Since current funded status of most employers are in the 60-70 percent range based on the recent annual valuation, this proposal would not impact most employer contributions in the near term. However, as stated above the proposal would increase the cost of a limited number of public agency rate plans that are overfunded i.e. contribute currently less than the normal cost.

If this bill is enacted, the affected public agencies mentioned above would be required to contribute additional contribution in 2011-12 estimated at about $2.9 million.

Administrative Cost:

Administrative costs are unknown but staff would anticipate significant one-time implementation costs to build this functionality into the PSR system. In addition there will be on going administrative costs to track, account for, report on , and invest the TARP account assets regardless of whether it is ultimately decided to include the assets within or outside the PERF.

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